Quarterly News

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Geneva, July 17, 2023

"And what the Chinese economists are worried about is that China may be falling into what I call balance-sheet recession. And balance-sheet recession is triggered by this whole notion that people feel uncomfortable with their balance sheets, suppose their debt is too large relative to their assets. And that typically happens after bursting of a bubble. If the bubble is financed with debt and asset prices collapse, but the liabilities remain, people realize that their balance sheets are underwater, and if the balance sheet isunderwater, you have to fix it.

And China got this huge bubble, especially in residential real estate. And the amount of price increase that China observed on the residential real estate is almost the same as what happened to Japan 30 years ago in Tokyo and Osaka."

Excerpt from a Bloomberg interview with Richard Koo, Nomura Research Institute chief economist, on the Japanification of China

Dear Sir, Dear Madam,

Compared to the preceding quarters, Q2 2023 proved to be of the mild sort, with most stock markets either inching higher or consolidating the gains from earlier in the year. Despite all the handwringing after the collapse of Silicon Valley Bank and Credit Suisse, there were no more bank failures of note and, although inflation remains an issue, it is receding month by month.

For a good idea of where inflation is heading, look no further than Switzerland, where the year-on-year CPI headline number has already fallen below the 2% arbitrary threshold aimed at by most central banks. In fact, the Swiss CPI, at 1.7%, is already lower than the 3-Month SNB rate of 1.75%. Switzerland is the first developed country to see its inflation reach such low levels mostly because of the strength of the Swiss franc and because it must import many goods and services (which are cheaper because of the aforementioned CHF strength). But if Switzerland is leading the way, it is quite clear that the other developed economies are also on their way to lower inflation.

Quite honestly, we could end this quarterly letter at this point, because there is not much more to say about the quarter. We do see, however, two interesting talking points we think are worth mentioning. The first one is China and the second one is Artificial Intelligence.

We have written many times before about China, mostly about how its residential real estate market bubble, when (not if) it burst, would be a huge issue for the country and its government and how a communist dictatorship is particularly ill-equipped to be able to deal with such an event.

Well, it's all happening right now. After an abrupt U-turn on its extremely strict Covid policies, China experienced a brief burst of wild consumer spending, which came as no great surprise since its citizens had been stuck at home for the better part of two years.

This burst of consumer spending proved to be some kind of last hurrah before things turned sour for the Chinese economy. While consumers spent, residential real estate prices kept on falling, triggering what Richard Koo, Nomura Research Institute chief economist, calls a balance sheet recession (see his quote at the top of the letter).

Richard Koo is THE specialist on balance sheet recessions. In fact, he coined the term in his wonderful book on Japan, "The Holy Grail of Macroeconomics", in which he tried to explain why Japan could not escape the downturn which had begun in 1990. He has now coined a new term, "The Japanification of the Chinese Economy" and he is in hot demand all around China as policymakers are grappling with a phenomenon strikingly similar with what happened in Japan.

To keep it brief (and again, the quote at the top of the letter sums it up well), balance sheet recessions occur when a wide swath of the economy finds itself underwater on its balance sheet and must therefore save money to repair said balance sheet. This generally occurs with leveraged investments, typically real estate. And when a big part of the economy stops spending and start saving, the economy collapses. What is good for one household is poison on a macro level. Koo's advice is for the other part of the economy (in this case, the public sector) to start spending in order to even things out and stabilize the economy.

This is something we also experienced in the US and Europe after the real estate bubbles burst in 2008 and we are still feeling the aftermath, in Europe in particular, where most policymakers decided to pointedly not spend public money. What followed was a lost decade with little to no growth and wealth mostly flowing to the richest strata. This only changed due to Covid, and it should come as no surprise that unemployment in Europe is now at its lowest levels in decades.

And now it is China's turn to experience a balance sheet recession, and it will be a doozy, because real estate prices there really went completely crazy. Again, the only possible comparison in is Japan 1989, which, until now, proved to be the biggest real estate bubble in modern times. When the bubble burst in 1990, Japan simply disappeared of the world economic map (although is stayed the number 2 economy in the world until China took over relatively recently).

At the time, Japan was ill-equipped to deal with the downfall, with its kind-of one-party democracy and huge reluctance to accept foreigners' suggestions on how to deal with such an event. Now, more than thirty years later, Japan seems to be coming out of its lethargy, although the Nikkei 225 index has yet to regain its previous 1989 top.

What we have with China now, however, is Japan on steroids, because residential real estate represents 25 to 30% of the Chinese economy and 60 to 80% of its citizens wealth.

What As prices start to fall, everyone will suffer, from borrowers with mortgages they can no longer repay to banks with bad loan books they have to clean up. And if Japan was already ill-equipped to deal with that, at least its institutions were somewhat flexible. That is not the case in China, where communist rule has become, if anything, even more rigid over the past five years.

The first moves to counter the downturn are the same ineffective measures used elsewhere before: lower interest rates and ease lending standards. But when consumers no longer want to borrow (since they already are overleveraged) and banks no longer want to lend (their loan books are too big and underwater), this has zero effects.

As Richard Koo explained, the only possible way to soften the blow is for the public sector to start spending more. But here again, Chinese leadership seems very reluctant to adopt this approach, also because the tax system in China is incredibly patchy. Unbelievably for a communist country, there is no national income tax.

This will be a big story that we will follow and update you on very closely.

Now, to the second subject: artificial intelligence (AI). As write this letter, we realize ChatGPT could perhaps do a faster (and maybe even better?) job than we can. It had been a while since so many of you had not asked us the same sort of question: is AI the next industrial revolution? Is it just hype? Do you use it? Will it kill many jobs?

In order to try to answer these questions (without asking ChatGPT), we first have to make a point we have made before: bubbles are inherent in a capitalistic system. Most bubbles remain rather small, have little to no impact on the global economy and wither and die (or stagnate) after a while. The 3D-printing craze of the 2010's comes to mind. Back then, many saw this new technology as the future of industry. It might yet turn out to be true, but so far it hasn't happened.

Something similar happened more recently with cryptocurrencies, which not a few people saw as the future of money. No more central banks printing money, just a clean and emotionless algorithm minting ever fewer cryptocoins. We have always told you that cryptocurrencies were a solution in search of a problem that did not exist and that states would not be willing to abandon one of their monopolies so easily. So far, we see nothing that changes our analysis. Bitcoin is probably here to stay, but to what extent and how much it will really be used in our daily lives remains to be seen. A revolution it was not.

And now we face the AI conundrum. Is it just as much hype as real technology? It is perhaps too soon to tell. To us, the mere us of the term artificial intelligence is problematic. It was coined back in the 1950's and implies, to many of us, killer robots taking over the world and getting rid of humanity (thanks Skynet from the movie Terminator). Artificial Intelligence as it stands today is clearly artificial and there is not much intelligence to be seen.

A better term for what AI really does is applied probabilities. If you have tried ChatGPT, you have probably come out impressed, as have we.

But you have to understand how it works. At its core, it is a number-crunching probability calculator. As one word comes out, it computes probabilistically what the next, most appropriate, word should be. It does not realize what it is writing, it is not thinking of the next paragraph or what the ultimate point of the article should be. It just computes at a very fast, inhumane, rate.

In that sense, AI is mostly hype, although it has become a huge help for many white-collar workers. It will not replace workers just yet, but certainly workers who know how to use it will be better off than the ones who want to have nothing to do with it. We will expand on this subject in future letters, and at a conference we are planning at summer's end. There are clear investment implications, both in terms of what one should invest in and, perhaps more importantly, what one should avoid.

What is clear to us, however, is that we are still in the very early stages of this AI revolution and that, contrary to the 3D and cryptocurrency hype, this could turn out to be a true revolution, on par with the Telecoms and Internet revolution of the late 1990s. It is still a conjecture on our part, but we must be cognizant of it and we will follow future developments extremely closely.

All the best,

Your CaridaB Group team